



Office of Audit Services
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June 16, 2006

AGENDA ITEM 5

TO: MEMBERS OF THE FINANCE COMMITTEE

- I. SUBJECT:** Risk Assessments
- II. PROGRAM:** Audit Services
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

The Office of Audit Services has completed an annual risk assessment as required by the Standards for the Professional Practice of Internal Auditing. This assessment covers all areas of CalPERS' enterprise, including public contracting agencies, internal operations, and third-party administrators acting on CalPERS' behalf.

The risk assessments we will discuss are for the purposes of audit planning and identification of audit coverage over CalPERS' operations. For this purpose, risk assessment is a means of systematically analyzing a very large body of information regarding potential areas of audit and scoring and ranking each auditable area based on a number of risk factors. The annual audit risk assessment serves as a tool to organize and assess areas of risk and allocate audit resources effectively to ensure adequate coverage of risk areas. Business risk is inherent in all organizations and must be present to add value. The identification and valuation of risk within the organization is not necessarily an indicator of a problem or threat to the organization if the entity receives a high score. Risk assessments assist management and the Finance Committee in gauging the amount of audit coverage necessary to further evaluate and monitor potential exposures to business risk.

The Office of Audit Services applies a risk-based approach to performing membership and payroll reviews of public contracting agencies, internal audits and consulting services, and facilitates external audits.

Public Contracting Agencies – includes public agencies, schools, district agricultural associations, California State University system and state agencies.

Internal Audit and Consulting Services – includes all of CalPERS' internal core business operations, including Retirement, Health, and Investments, as well as support functions such as Fiscal, Information Technology Services, and Human Resources.

External Audits – the Office of Audit Services serves as audit liaison for all external audits that take place with CalPERS, such as the annual financial statement audit, real estate audits, R Street audits, and externally-initiated audits such as those conducted by the Bureau of State Audits or the federal government. All findings and resolution of external audits are reported to the Finance Committee through the Office of Audit Services.

Membership and Payroll Reviews

The Contracting Public Agency program evaluates and validates the integrity and accuracy of membership and payroll data reported to CalPERS by employers that contract with CalPERS for retirement benefits. The membership and payroll reviews focus specifically on compensation reporting, member enrollment, payroll reporting elements, timeliness of industrial disability retirement determinations, reporting unused sick leave for additional service credit, and reinstatement of retired annuitants. We also review the validity of members' health enrollment eligibility and confirm that controls established to utilize the Automated Communication Exchange System (ACES) are being properly followed.

Contracting Public Agency Risk Assessment

As part of the Office of Audit Services fiscal year 2006-07 annual plan, a risk assessment was conducted of all contracting and mandated employers to identify and prioritize entities based on risk values assigned to the entity. The risk assessment process utilized factors such as agency size, agency type, safety coverage, unused sick leave provisions, history of late payroll reporting, missed payroll reporting periods, highly paid employees, reported changes in earnings and whether the agency received CalPERS training. The results of the risk assessment prioritize each entity in low, medium, or high categories of risk scores to determine the best use of staff resources.

The Office of Audit Services allocates 14,000 hours for contracting public agency reviews in the fiscal year 2006-07 audit plan. Forty-seven membership and payroll reviews should be completed annually with this level of staff resources.

Attachment A gives a brief history of the membership and payroll review program and shows the risk assessment results.

Internal Audit and Consulting Services

Internal Audits performs assurance and consulting work, consistent with the International Standards for the Professional Practice of Internal Auditing, and covers areas including retirement, health, investments, information technology, fiscal, operations support, and other internal areas. Internal audits provide assurance that 1) assets are safeguarded, 2) evaluate the efficiency and effectiveness of operations, and 3) ensure compliance with laws, regulations, and policies.

Internal Audits Risk Assessment

The goal of the annual risk assessment is to establish risk-based audit plans to determine the priorities of internal audit activity, consistent with the organization's goals (Performance standard 2010, International Standards for Professional Practice Internal Auditing). Our approach includes reviewing business area objectives, strategic plans, key projects, operations summaries, organization charts, committee agendas, internal division web pages, articles and professional publications, other public pension funds, and other resources. We then interview division management to discuss obstacles that could hinder achievement of business goals and objectives, upcoming changes, and to obtain their viewpoints and input on potential risk and opportunities for each business area.

Each year, the Office of Audit Services enhances and further refines the approach for auditable areas, both internally and externally. We identified not only main lines of business but also auditable entities. We then prepared an "audit heat map" for each of the core business areas, and support areas, shown in Attachments B through E. The heat maps depict recent past audit coverage, and planned audit coverage for all identified auditable areas consisting of 249 auditable entities.

A further enhancement is the identification of primary third-party administrators for CalPERS. We identified the population of contractors upon which CalPERS relies to perform or act in the capacity of CalPERS' fiduciary responsibility or provides services to CalPERS members. We also identified the current extent of audit coverage provided, as shown in Attachment F. Several of the major contracts are already regularly included in our audit plan, so we depict these both on the heat map of past and future audit coverage, as well as in the list of third-party administrators. The heat maps also show if CalPERS' contract with the

third party administrators includes audit coverage by external audits, SAS 70 reports, the extent of internal audit coverage, if the contract includes fiduciary responsibilities, and if the third party administrator contract includes audit access clauses.

Those areas showing previous audit coverage were categorized with high risk values, as a result of prior year risk assessments or were recurring or mandated audits. Those areas identified for audits during the 2006-07 and 2007-08 audit periods fall under the category of high risk values as a result of the current year risk assessment. We implemented our plan to add incremental audits of third-party administrators in the proposed plan and have increased the number of reviews in external investment areas.

Following the identification of the audit universe, we apply the risk factors and scoring of each item. Risk criteria and factors include: assessed adequacy and effectiveness of programmed controls, character and complexity of the business activity and its underlying systems, dollar size or transaction volume, management interest, sensitivity of the application information, results and time of previous audits, and degree of changes in operations. We then score all risk factors for each auditable entity, to arrive at an overall risk assessment. The risk assessment is a key factor in development of the Biennial Audit Plan, which we will present to the Committee for approval in Agenda Item 6.

V. STRATEGIC PLAN:

This item is not a specific product of the Strategic Plan, but is part of the audit planning process prescribed by the Finance Committee Charter, the Office of Audit Services Charter and the Standards for the Professional Practice of Internal Auditing.

VI. RESULTS/COSTS:

The planned work of the Office of Audit Services will provide broad oversight for the Board of Administration, its Committees, and CalPERS management.

Staff is available to answer any questions that Committee members may have.

Original Signed by Larry Jensen

Larry Jensen, Chief
Office of Audit Services

Original Signed by Peter Mixon

Peter H. Mixon
General Counsel

Attachments

ATTACHMENT A

AGENDA ITEM 5

ATTACHMENT B

AGENDA ITEM 5

ATTACHMENT C

AGENDA ITEM 5

ATTACHMENT D

AGENDA ITEM 5

ATTACHMENT E

AGENDA ITEM 5

ATTACHMENT F

AGENDA ITEM 5